RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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August 15, 1979 **LETTER 763**

Aug 3, DJIA 846.16; PTI 1071; A-D Ratio –17.67
Aug. 10, DJIA 867.06; PTI 1093; A-D Ratio –16.74

THE PICTURE: I can't prove it, and the actual statistics don't show it yet–but it seems to me that the various markets are saying that THE RATE OF INFLATION IS PEAKING. Why do I say this?

(1) The very sensitive commodity markets are in shambles. They've topped out. Cattle and hogs have collapsed. The grains have had sickening declines. And perhaps most important, the metals (except for copper) appear to have made tops. Platinum has come down hard. Silver gapped down from its recent high and broke a 7 month trend. And gold (after 2 limit-down days in the futures market) has cracked its short-term trendline and its 4-week moving average.

(2) I believe the *long* end (and perhaps even the short end) of the money market instruments have seen their lows. The bond rally goes on, and I believe that the bond market saw its lows in May. I doubt if those lows will be broken.

(3) The stock market (as always) is "in the know," and stocks are moving up as they discount the end of the rise in the inflation rate. In other words, stocks act as if the peak in the inflation rate has PASSED.

(4) Consumer confidence is at a 4-year low and consumer buying has eased (in autos it has been cut back sharply). Price increases are going to be harder to pass on in this kind of atmosphere, and inventories are going to be cut (which should create some "bargains" at the retail level.

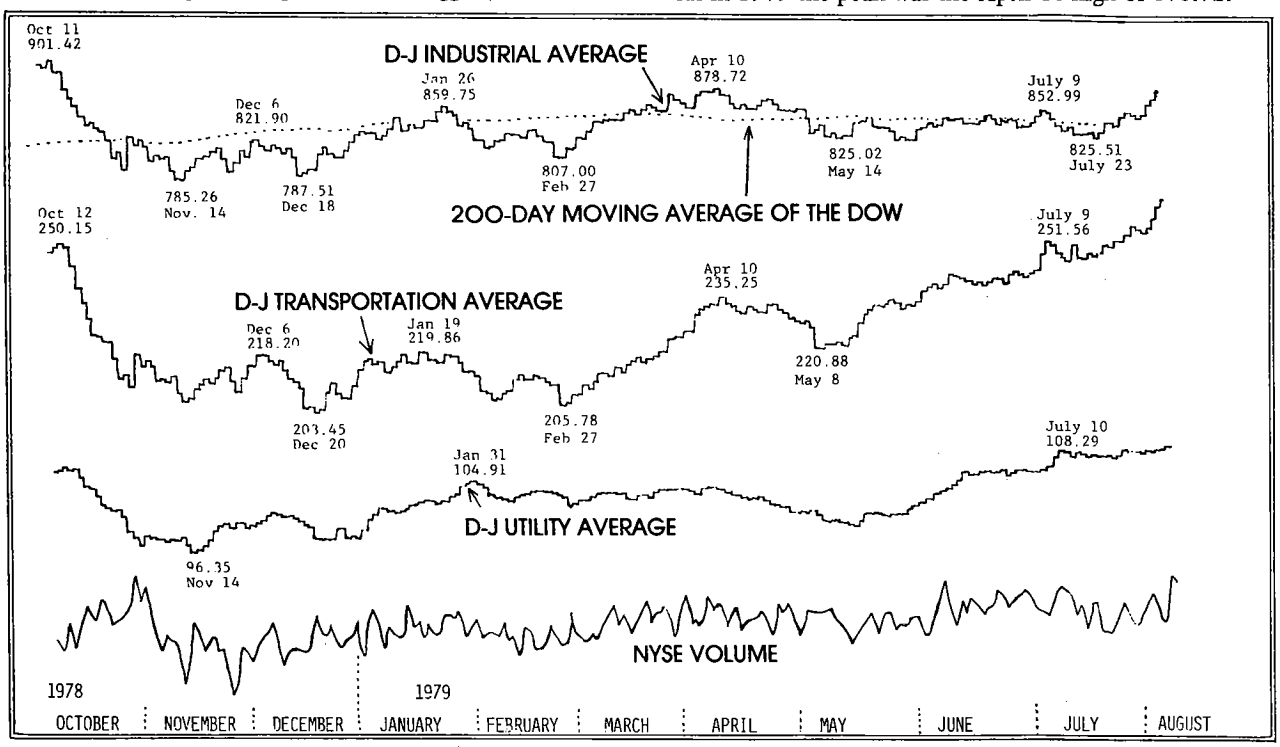
(5) The oil and gas shortage seems to be over, and a number of OPEC nations are cutting their exports, which suggests to me that it is getting more difficult to sustain the oil price structure. If the US goes into recession, I would expect oil prices to back off.

(6) I am of the opinion that last October saw the highs for "hard currencies" (franc, mark, yen) against the dollar. During July the Swiss franc and the German mark had every chance to break out (in terms of dollars) and attack their earlier peaks. The rallies failed. Nobody can believe it, but the strength of the dollar continues.

Many men have had the ability (or the genius) to look ahead and literally "see" the future. But few are those who can forecast how the market will REACT to their predictions (even when those predictions come true!). Over the past year inflation heated up to almost frightening levels, but the market tended to hold its ground. Now there seems to be a good chance that inflation is peaking, and the market evidently likes what it sees. No wonder those who invest on the basis of what they read in Time or Newsweek are frustrated. No wonder that the market has been called "its own best forecaster."

STOCK MARKET: I had expected July to be a critical month for the stock market. But the market could not have been less interested in my theories. July came and went with notable lack of drama or fanfare. All of which underscores what every seasoned market veteran knows: it is far easier to IDENTIFY a top or bottom than it is to predict one.

The Dow Industrial Average has traced out a downside progression for the past 4 years. In 1976 the Dow hit a peak of 1014.79. In 1977 the peak was 999.75. In 1978 the peak was 907.74. So far in 1979 the peak was the April 10 high of 878.72.



If the Dow can now rally above 907.74 it will have done something that it has not been able to do since 1976–that is to better the preceding year's high.

The previous major high for the Transportation Average was the 261.49 peak recorded September 8, 1978. That was the highest closing price for Transports since 1969. On August 8, 1979 the Transports bettered the 261.49 level, thereby rising to their highest price in 10 years!

From the standpoint of Dow Theory, the new Transport high leaves us in a rather strange situation. One can say that the new carrier high represents a major non-confirmation. Or one can say that past history shows that the majority of primary penetrations by one Average are, in time, confirmed by the other.

My own feeling is that the action of the Industrials will be particularly important from here on. If Industrials gather strength and cross their first barrier (the 1978 high of 907.74), we will have a large plus added to the technical picture. But if, in the face of the new Transport high, Industrials are still unable to reverse their downtrend since 1976, the situation will look less appetizing to me.

I have been asked, "What would it mean if Industrials now better the 907.74 1978 high?" In recent Letters I stated that the Dow-type stocks are selling in many cases below book or replacement value, they are selling at very low price/earnings ratios and at attractive yields. If 907.74 and 261.49 are bettered, it could mean that large interests are coming in to buy these "Dow bargains" and that a major move is on.

A few Letters back I recommended the purchase of Madison Fund and US & Foreign Securities on the premise that a bull move could be coming up. In the last Letter I listed the 8 strongest Dow stocks on the theory that if the Dow takes off on the upside, then the stronger Dow stocks will represent the gas in the Dow engine.

The top 7 lineup this week is as follows, based on the 13-week rate of growth: **Westinghouse, Allied Chem., Standard of Calif., Union Carbide, General Food, Amer. Brands, Exxon.** It would be hard to envision the Dow moving higher without these 7 stocks being in the forefront of the move.

Before we break into applause or render a series of bullish handstands, it would be well to remember the following: (1) The market is now quite over-bought, (2) the monetary and bank credit background is still bearish, (3) we are nearing the period of the greatest seasonal weakness, and I am talking about September-October. Many a market move has "looked good" right into late-August or early September, only to end in a frightening swoon during the September-October time period.

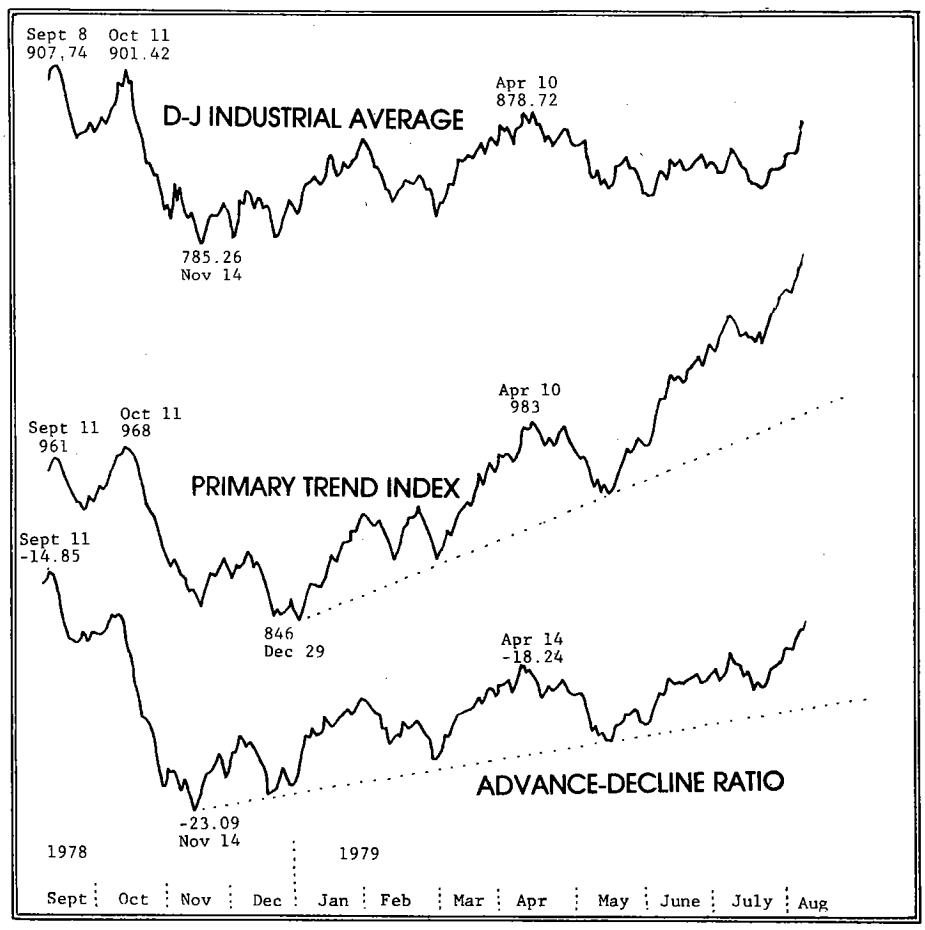
PTI: Higher, lower or sideways, win or lose, the market is always providing us with lessons. It's our job to learn the lessons, and veteran market practitioners know that school is never out.

I'd say that 1979's lesson is that "the market is a law unto itself." In all the years I've been studying the market, I've never seen so many people and rules foiled by "ol' man Wall Street." I could go through most of the list, the bank credit studies (bearish), the monetary studies (bearish), the price-volume studies (bearish), the basic values concepts (bullish), the Elliott Wave Studies (bullish), the most-active stocks and the high-low statistics (bullish) and on and on. You name it, and this market has thwarted it, gone against it, frustrated it. It's been an incredible market.

Back in the late-1960's I spent a lot of time with various indicators and combinations of indicators. What I was looking for was a device which would show the cumulative gains or losses of both technical strength and price in the market. The indicator would have to INCLUDE enough basic data so that it **could not be fooled.** I wanted to feed into this indicator such diversified action as interest rates, price action in the Averages, daily new highs and lows, advance-decline data, bond action. In other words, I was trying to develop an indicator which, by construction, could not be "fooled" by the market in the way that most individual indicators ultimately are fooled.

For example, there are long periods when the general market will sag while the Dow holds. There are periods when the bond market sags while stocks move higher. There are periods where Standard & Poor's 500 rises while the Dow moves sideways. The indicator I was looking for would best express the average action of a number of critical indices.

After all sorts of tests and false starts, I came up with my Primary Trend Index (PTI). This is an amalgam of the 8 most basic averages and indices that I could find. The construction of the PTI and the basic data that went into it was easy enough. But I simply did not have the time or energy to run the PTI back 10 to 20 years. So I embarked on a project of computing the PTI daily with the thought that 5, 10, or 15 years hence I would have a device that would be invaluable in interpreting the market.



As matters turned out, I was not disappointed. I have computed the PTI daily since 1971 so that I now have 9 years of back data. I have watched the PTI as it traced out its daily pattern against actual events. My biggest failing during that whole period came when I did not give the PTI credence. But I was learning how to interpret it (I still am), and I was trying to decide how far to trust it.

Here are a few of my observations and "rules" regarding the PTI. I think they should be of use to subscribers. Non-confirmation between the PTI and the Dow can be important, but ONLY when a non-confirmation results in a rapid reversal of trend. For instance, note on the PTI chart in this Letter that the non-confirmation series of September-October resulted in a reversal to the downside in both the Dow and the PTI. This action was bearish in that the PTI (after October 11) "decided" to follow the weakness of the Dow. When BOTH the Dow and the PTI started sliding (following the non-confirmation), we had the so-called "October massacre."

Note that currently (page 2 chart) we have another series of non-confirmations with new highs in the PTI, so far unconfirmed by the Dow. But the PTI this time keeps pushing higher–**despite the reluctance of the Dow.** PTI strength continues, and this means that market strength is still intact.

So the basic rule is that as long as the PTI continues to advance (regardless of ANY OTHER fundamental or technical consideration), the broad direction of equities is to the bull side. Shorts and put options should obviously be avoided as long as the PTI is in a bullish trend. The converse is true when the PTI is in a bearish trend.

The PTI works well with trendline analysis, but I have had the best results in interpreting the PTI by simply insisting that bull trends better previous peaks and bear trends break preceding lows.

The PTI often provides excellent danger signals during bear market rallies. At such times it tends to rally weakly, then flatten out–even though the Dow explodes upward. This kind of action was seen repeatedly during the 1973-74 crash. During declines within an ongoing bull market the PTI tends to resist stubbornly on the downside, while making up for losses quickly during ensuing market rallies. In other words, the PTI tends to lead the Dow and usually the rest of the market.

Rule: don't argue with the PTI, try to position yourself with its long-term trends. When in a bull trend, try to position yourself in the strongest stock groups regardless of what any other individual average or indicator or study is telling you. When the PTI is in a bear trend, be out of the market and be liquid.

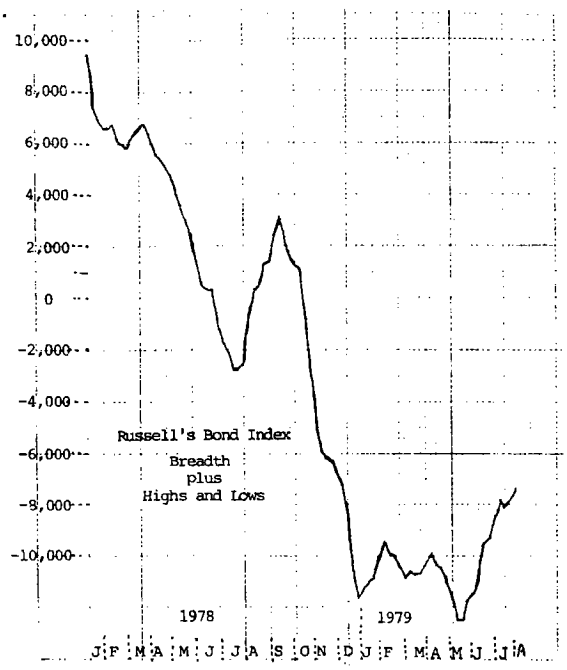
Conclusion: I want to insert this piece (it's one of my favorites) written by the great Robert Rhea in his Dow Theory mailing of June 2, 1934: *"Most investors are familiar with the cocksure type of service which, when followed by the unwary, proves ultimately to lead to disaster. The opinion of almost any intelligent man, if it is independently formed, is a better one than can be expressed by the quacks who claim infallibility as market prognosticators. Some services are always positive. In the long run, they may be right half the time. They ballyhoo their correct guesses and hush-hush their wrong ones."*

I don't know why the PTI is rising in the face of bearish monetary conditions and a recession, the depth of which nobody can measure. I don't know why the D-J Industrial Average has been refusing to follow the lead of the PTI. But I do know that following the December 29 low of 846 on the PTI, the PTI has pushed steadily higher on a trendline basis. As of this writing, the PTI is at yet another new high.

My interpretation of this action is even though the market is "worried" and somewhat ragged, the technical strength is holding intact. It's a rather difficult market to make money in, but it's certainly not a market to be short in.

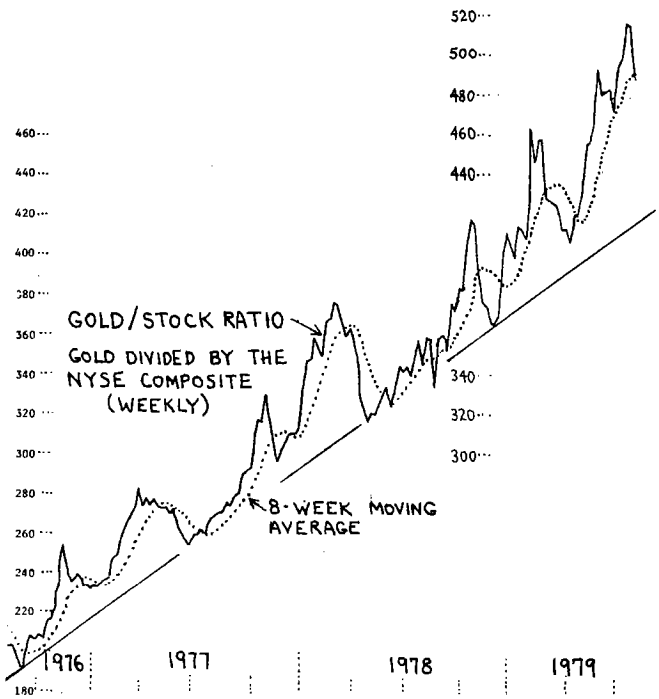
Ultimately, the PTI will take its cue from the lagging Dow and A-D Ratio and weaken–or the stubborn strength in the PTI will drag all the Averages to new recovery highs. The best strategy I can come up with in this kind of market is one of **diversification.** That means 10% or even more now in gold, a position of perhaps 15-20% in one of the closed end funds such as Madison or US & Foreign Securities, a position of perhaps 25% in assorted bond funds, and perhaps 40-50% in liquid assets such as Treasury bills or a liquid assets fund.

CHARTS: This seems like a good time to back up some of my opinions in terms of charts. First, I believe my special bond market indicator (daily advances plus daily new highs MINUS daily declines minus daily new lows) is telling us that the bond market has seen its lows–at least for quite a while. The recent bond market action has been very impressive. Down weeks have become almost a rarity, despite the recent discount rate boost and despite all ominous forecasts of "booming interest rates." What we are seeing could be merely an upward correction of the drastic 1978-79 bond crash, but if this bond advance regains only half of the 1978-79 losses, it is fated to be impressive on the upside.



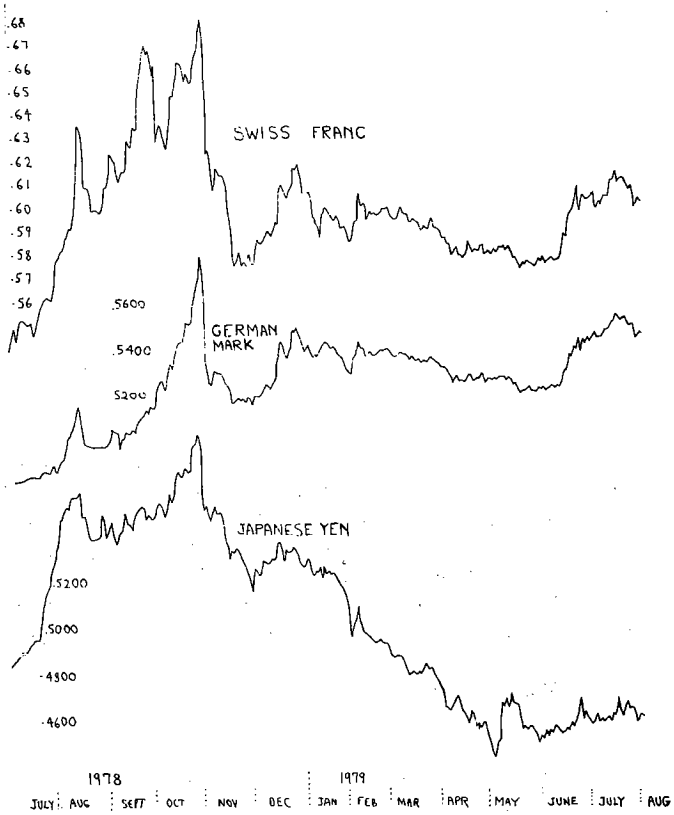
The second chart shows London gold (weekly) and the Dow. These two items have diverged ever since August, 1976, with the trend of gold sharply higher and the trend of the Dow down. I don't know how much longer this divergence is going to continue, and I'm thinking that we could be near a turn. A price of 260 would rupture the steeper trendline in gold, while a price of 230 would reverse the much more important 3-year uptrend. (Chart courtesy of Security Research, 208 Newbury St., Boston, Mass. 02116).

It would require a value of 890 to turn the Dow to the upside, but unfortunately 890-900 would also find the market in very over-bought condition. At any rate, here's a chart to watch



carefully. We'll all know if and when the persistent trends shown here are reversed.

The dollar, despised, feared, spat upon, has (surprise) still not relinquished its strength. Last October the hard currencies gapped down against the dollar. Note on this chart that during July the franc and the mark moved up to challenge the dollar. But the move (so far) has not been successful, and the franc and the mark have faded to some extent. The yen, weakest of the major currencies, has not even put on an impressive rally against the dollar. Meanwhile, the British pound (not shown) has become the strongman of currencies. With a stiff 14% bank loan rate and Maggie Thatcher at the helm, Britain may be in the process of coming back to life. Stranger things have happened!



NOTES & QUOTES: I've been reading the Wall Street Journal for a long time, but I must say that their editorial page is getting better and better. If you don't read the Journal editorials, you're missing the best, most balanced, most intelligent commentary to appear anywhere in the mass media today.

By the way, there are only two national newspapers in the US today, the WSJ and the excellent Christian Science Monitor. I find it a pleasure and an education to read them.

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I carry chart books of the D-J Averages (daily Industrials, Transports, Utilities, Bond Average and daily volume) with a page devoted to each year. The pages go back to 1885. Price for this 3-ring hard cover album (a new page is published at the end of each year @ $2) is $49 ($52 for Californians).

I had also published a chart book of the daily advance-decline ratio (NYSE) going back to 1931. I have been out of this book for a few years, and I am not going to reprint it. However, I just found 9 volumes of the A-D chart book which I will sell on a first-check-received basis. The books will be updated through 1978 and the price (3-ring binder with a new page published each year @ $2) will be $50 ($53 for Californians). Both of these albums should be invaluable to serious market students.

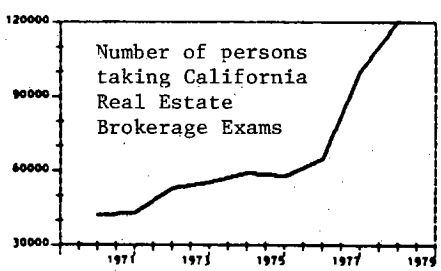
* *

As a follow-up on the last Letter's stamp item, I note that Walter Perschke (he publishes the numismatic letter) just bought the famous gold Brasher Doubloon. Perschke paid the highest price ever paid for any coin, $430,000 (there are only 7 of these coins in existence, and only two in private hands). Walter was asked in an NBC-TV interview why he paid $430,000 for a single coin. He answered, "because someone else bid $420,000." Now there's a dry wit!

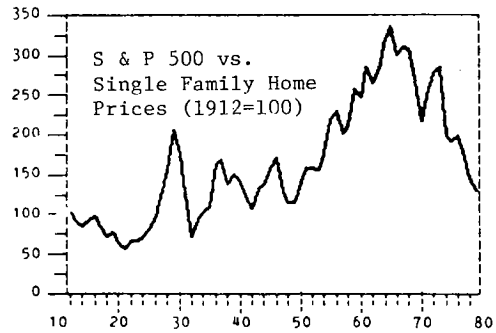
* *

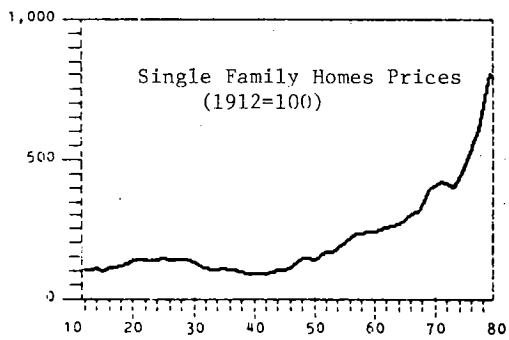
Many years ago (during the mid-1960's) I published a chart of the growth of registered representatives in the stock brokerage business. It was, to say the least, a "growth chart." What had happened, of course, was the rising prices of stocks had lured thousands of men into the stock brokerage business. Alas, that chart topped out years ago.

Now I present a new growth chart. This chart shows the number of people taking the Department of Real Estate exam in California. I'd call this a growth chart, wouldn't you!



Here's another fascinating chart, showing the price of the S&P 500 Stock Averages vs. single family home prices. Does that give you a hint as to why registered reps are out and real estate brokers are in? The third chart shows you the price of single family homes from 1910 to 1979. The conclusion: every salesman likes to think that he "makes the action" but in terms of the big picture the action tends to make the salesman.





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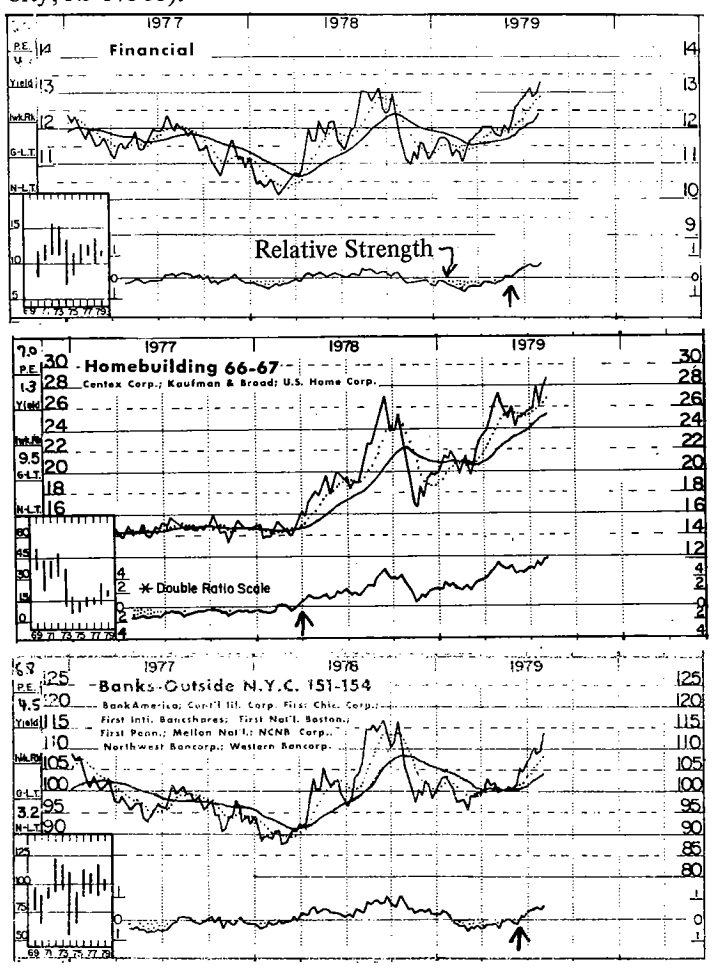
I've been reading a lot recently about the "coming real estate collapse" as well as the "coming bank collapse." But I'm also a market man, and there isn't going to be a collapse as long as these charts are showing superior relative strength. Let me put it another way: the market will sense trouble in real estate and the banks and S&L's BEFORE we do. And they just don't see it yet. (Charts courtesy of Mansfield, 26 Journal Sq., Jersey City, NJ 07306).



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Here's a clip from Newsweek (Aug. 13), and it's clear that Congress is looking ahead. What it sees and what will actually happen is often far, far apart. But after all, if Congress isn't expert on inflation–then who is? Congress is the body that votes for all those deficit boondoggles and unfunded dream-schemes.

> The Joint Economic Committee of Congress will release a study next week projecting a U.S. inflation rate of more than 140% over the next decade. It reports that the average price of a house could rise from $55,000 to $150,000 in 1990. A car now priced at $6,000 could top $12,000. A loaf of bread might cost $2. The committee says inflation could be halved if the government stimulates savings, investment and productivity.

* *

The piece below by Joe Granville (Granville Letter, Drawer O, Holly Hill, FL 32017) struck me as the perfect item to follow the Congressional inflation piece. What do the poor slobs do who see all their earnings and savings either taxed away or inflated away? Why it's simple. They turn masochistic and throw it away at the gambling casinos. Joe calls gambling "the number 1 growth industry in America today." Gosh, and I thought it was dope, or was it embezzling? Anyway, here's the heartening picture that Joe saw: "*As I write this portion of my letter, I am in Atlantic City across the street from the Resorts International Casino where I will be speaking next month. The scene is almost beyond belief. I have been in every casino in Las Vegas but I have never seen a sight such as I have seen here at Resorts. There is a simply enormous room literally filled with wall-to-wall people. One can hardly move about. As one leaves the casino, another tremendous throng is outside waiting to get in. Nine blocks sough of here is the equally mobbed Boardwalk Regency, the Caesars' casino. Out in the streets of Atlantic City are teaming throngs of tourists crawling over the city like a human ant hill.*"

* *

I wake up in the middle of the night on occasion, and I find myself in the grip of icy fear. The fear centers on what's happening in this country. Then in order to get to sleep again I attempt to turn my fears into fantasies. Last night I came up with two solutions for our problems. (1) We trade Jimmy Carter for Margaret Thatcher for a one-year trial period. If things improve, we make the arrangement permanent. (2) We bring Saudi Arabia in as the 53rd state in the Union. If Israel screams, we make her 54th.

Evidently, Woody Allen shares some of my own fears. I happened to read his latest untitled essay on the state of the world, and it starts out like this:

> **More than any other time in history, mankind faces a crossroads. One path leads to despair and utter hopelessness. The other, to total extinction. Let us pray we have the wisdom to choose correctly.**

* *

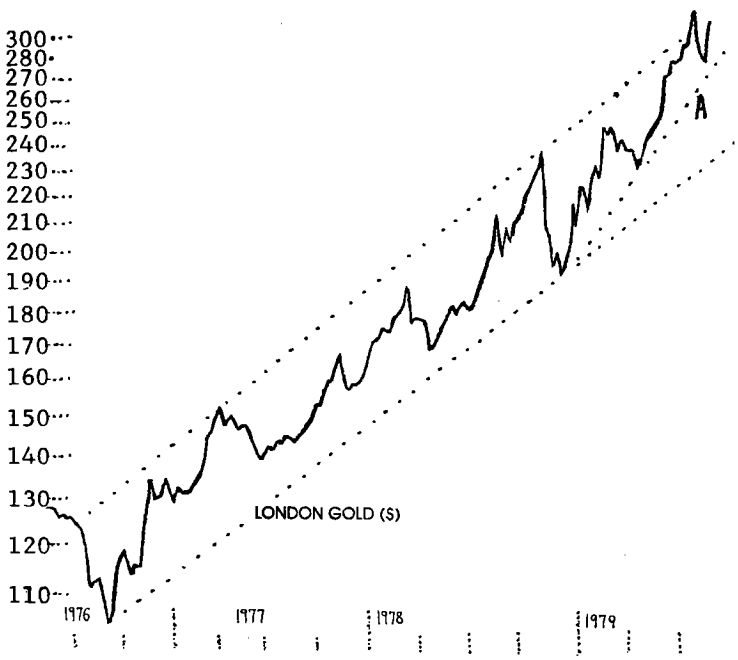
All is not lost on the tax front. At least the Wizard of Id is pointing out the benefits thereof (see below).

THE WIZARD OF ID
I SEE A TAX REVOLT!
REALLY?
...THE PEOPLE ARE STORMING THE CASTLE!
...HOWEVER, THEY ARE BEATEN INTO SUBMISSION
ANOTHER EXAMPLE OF YOUR TAX DOLLAR AT WORK.

GOLD: I've followed gold for longer than I like to think. It's always been an easy item to track, and I used to say that "gold is a perfect item to chart." That's just not true any longer. I was talking to Walt Bressert last week (president of the nationally known HAL Commodities), and we were both saying that the commodities in general and gold in particular are very tricky, very tough to track these days. The reason: probably too many players, too many people trying to beat the markets.

Since mid-1978 (when gold started to make the headlines) gold has been a deceptive and "cutesy" item. Gold will run up, break above a previous top, then turn around and crack its rising trendline (turning everyone bearish), then rush on its way to a new high again. In the face of that kind of action, my advice is "don't trade gold." Take your long-term position 10% or 15% or whatever you feel comfortable with–and just sit tight. I honestly don't think you can, at this time, beat the gold market via the trading route.

My weekly ratio chart of gold shows the most recent correction, which took gold to a level just above its steepest rising trendline (A on the chart). Actually, trendline A comes in at about 275 on current gold, so that the August decline to 281 held 6 points above trendline A. Gold then rallied back to within a few points of its 307 high.



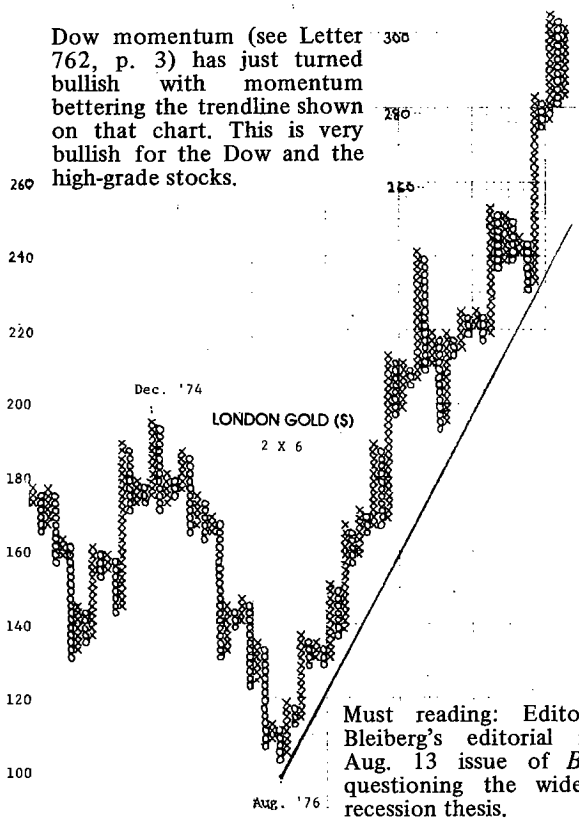
I obviously cannot tell at this time whether gold is going to surge above 307 to a new high–or whether gold is in the process of topping out. The gold stocks have been weak, and my gold stock average has broken below three minor bottoms. But so far, even weakness in the gold shares has not rubbed off on the metal.

As you can see on this chart and on the point & figure chart, gold has come a long way since 1976. Somewhere along the line, gold is going to need a rest. Below 275 would suggest that "the rest" is in process, above 275 and all is OK.

So far, gold is holding its correction to 10%. I'd be nervous with a trading position in gold here. With a long-term "survival" position, I wouldn't give gold's gyrations a second thought.

LATE FLASH!

Dow momentum (see Letter 762, p. 3) has just turned bullish with momentum bettering the trendline shown on that chart. This is very bullish for the Dow and the high-grade stocks.



Must reading: Editor Bob Bleiberg's editorial in the Aug. 13 issue of *Barron's* questioning the widely-held recession thesis.

LATE NOTES: Perhaps due to fear of the implications of the Chrysler mess, the short-term paper market (debt instruments) has weakened. Average yields on 6-month maturities went over 10% last week, for the first time in six months. But even this didn't unsettle the stock market. The Primary Trend Index (PTI) continues its relentless course to new high ground. I just don't get a bad day on the PTI, but the good days string out week after week. I have to call the action impressive.

Next to the PTI, the most-active stock index is the most powerful indicator. On good days the daily plurality of the most-actives (NYSE) runs +6 to +10. On down days the plurality is -3 or -4. It's strong action, no question about it.

At the big American Economic Council seminar in Los Angeles last week I presented a bullish near-term view of the stock market. The audience, I felt, could not have cared less. They were only interested in my projections for gold. I told them that there was a good chance that stocks could do better than gold in the months ahead. They just didn't want to hear that. I suggested that they keep an open mind on the markets. It's ridiculous to have a vested interest in anything but reality and the truth.

I continue to like the closed-end funds such as US & Foreign and Madison. Union Carbide has now turned bullish on long-term relative strength as has Williams Cos., GATX, Allegheny Ludlum, FMC, Xerox, and the whole NYC bank group. I like JP Morgan here, selling at a bit over 7 times earnings.

The lagging Industrials are the one thing that still bothers me about this market. I guess years of Dow Theory study leave their mark. It still seems to take an awful lot of steam under the market boiler to move the Dow up, and I'd like to see that feature of this market CHANGE.

NEXT MAILING: August 29th